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TO RUEHC/SECSTATE WASHDC 7966
RUEATRS/DEPT OF TREASURY WASHDC
INFO RUEHZS/ASSOCIATION OF SOUTHEAST ASIAN NATIONS
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEHRC/USDA FAS WASHDC
RUEHKO/AMEMBASSY TOKYO 1513
RUEHBJ/AMEMBASSY BEIJING 4716
RUEHBY/AMEMBASSY CANBERRA 1991
RUEHUL/AMEMBASSY SEOUL 4395
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UNCLAS SECTION 01 OF 03 JAKARTA 000286

SIPDIS

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DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA-SETH SEARLS AND JWEEKS
SINGAPORE FOR SBAKER
TOKYO FOR MGREWE
COMMERCE FOR 4430/BERLINGUETTE
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR TCURRAN
DEPARTMENT PASS EXIM BANK
USDA/FAS/OA YOST, MILLER, JACKSON
USDA/FAS/OCRA CRIKER, HIGGISTON, RADLER
USDA/FAS/OGA CHAUDRY, DWYER

E.O. 12598: N/A

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SUBJECT: SOARING FOOD PRICES PROMPT LARGE STABILIZATION PLAN

¶1. (SBU) Summary. Upward pressure on food prices in Indonesia is unlikely to subside in their near term, presenting considerable hardship for poor households. In an effort to combat food price inflation, the Government of Indonesia (GOI) announced a large-scale food price stabilization program. The program includes significant price subsidies, a reduction in import duties, a continuation of export duties, and incentives to increase and diversify crop production. The new program will have a substantial short- and potential long-term impact on government finances and policies. Analysts also question the sustainability and effectiveness of price subsidies to control inflation in Indonesia. End Summary.

Pressure on Food Prices Unlikely to Abate

¶2. (SBU) Pressure on food prices in Indonesia is unlikely to subside in their near term due to a host of international and domestic factors. A drought in Australia, other weather-related problems in the United States, Canada and Europe and a reduction in planted areas in the developed world have reduced global yields of wheat and soybeans. Demand for alternative energy sources has prompted farmers to increase corn and palm oil production for biofuel use at the expense of crops for human consumption. Land use policies that limit the size of plots available to individual farmers keep larger and more efficient farms from forming. The GOI approval process for hybrid seeds that could increase yields is extremely slow; the approval process for bioengineered seeds is worse. Indonesia's aging irrigation systems and poor rural infrastructure also limit the farmers' ability to respond to increased demand.

¶3. (SBU) Most analysts note that high food prices will eventually prompt supply side adjustments that bring food price inflation under control. However, this adjustment process may be slower than in previous cycles, particularly in Indonesia. While observers expect the Chinese and Indian economies to cool in the wake of the decline in US growth, most also expect food demand from those countries to remain robust. High oil prices will keep the demand for alternative energy sources elevated. Also, significant land and seed policy

changes and large levels of investment in rural infrastructure in Indonesia are unlikely.

Food Costs Exacerbate Poverty Levels

¶4. (SBU) Soaring food prices put significant pressure on Indonesia's poor and near poor, a group that represents over 40% of the population. Staple foods, such as rice, soybeans, and palm oil (used for cooking), which are now relatively high priced, comprise roughly 50% of these families' household budgets. Moreover, as food prices rise, the quality of food products available to poor families usually deteriorates, contributing to health problems. Anecdotal evidence suggests that last year's spike in rice prices forced poor families to consume rice containing mold and other contaminants. High rice prices are responsible the use of so-called "recycled" rice by low-income consumers, basically rice recovered from restaurant dust bins. Recent data suggest that higher food and energy prices have prompted stronger overall inflation in Indonesia. Headline inflation rose to 7.4% (YOY) in January, up from 6.6% (YOY) in December. The month-on-month increase in prices from December to January was 1.8%, up from 1.1% the previous month. If inflation expectations begin to rise, calls for wage increases, which put further pressure on prices, could also intensify.

Large-scale Stabilization Plan Announced

¶5. (SBU) The Yudhoyono government is under significant pressure to get food prices under control or risk significant backlash at the ballot box in 2009. GOI contacts have told us that this is one of the Yudhoyono administration's top priorities leading up to elections. On February 4, Deputy Chief for Coordination of Agriculture and Marine Resources Bayu Krisnamurthi announced a host

JAKARTA 00000286 002 OF 003

of new and ongoing policies designed to stabilize food prices. The policies include soybean price subsidies for small-scale producers (Rp 1,000 per kg), rice price subsidies (Rp. 1,600 kg) for 15 kg of rice per household per month, and cooking oil price subsidies (Rp. 2,500 per liter) for poor families. In addition, the GOI will temporarily eliminate import duties on flour and soybeans, and lower import duties on rice to Rp 450 per kg from Rp 550 per kg. The new policies also relax import standards for wheat.

¶6. (SBU) The stabilization plan includes provisions to raise the export tax for palm oil and derivative products from 10% to 15% and expand the categories of cooking oil eligible for government-paid value added tax for domestic sales. The GOI also announced policies to accelerate the provision of high quality seeds and promote the development of wheat alternatives.

Fiscal Cost High

¶7. (SBU) The total cost of the program and its financing remain unclear. On February 5, Indonesia's Energy Minister Purnomo Yusgianoro stated that the GOI would shift Rp 25 trillion (\$2.8 billion) in budget funds, previously allocated for fuel and electricity subsidies, to fund new food price subsidies. The Ministry of Energy (MOE) also stated that the shift in funds from fuel to food subsidies is dependent on the GOI changing its oil price budget assumption from \$60 a barrel to \$80 a barrel. According to our contacts at the Ministry of Finance, the change in assumption raises the total amount of funds allocated for fuel and electricity subsidies (before moving funds to the food sector) by Rp 69.1 trillion (\$7.6 billion) to Rp 144.7 trillion (\$15.9 billion). The GOI currently estimates that the price of the entire food stabilization package (including food subsidies, lower import duties and higher export taxes) will be Rp 13-14 trillion (\$1.4-\$1.5 billion).

¶8. (SBU) The large cost of the program will put pressure on the 2008 budget deficit, initially projected at 1.7% of GDP. The cost of the food stabilization program alone, at Rp 13-14 trillion, will raise the deficit by 0.4% of GDP, regardless of where the government

generates the funds. At the same time, Indonesia's budget is under pressure from rising oil prices. Changing the price assumption for fuel to \$80 a barrel will increase the budget deficit by 1.8% of GDP. The IMF calculates that every \$10 increase per barrel in the price of oil, worsens the fiscal balance by 0.1% of GDP, but notes that the impact is not linear as fuel smuggling and other issues come into play as well. Few analysts expect the actual global price of oil, currently close to \$90 a barrel, to drop in the near term, suggesting the actual cost of energy subsidies may be even higher. (Note: The GOI will partially fund the food subsidy program by diverting funds from energy subsidies, meaning the total impact of the food price package and raising the budget assumption will be less than the sum of their impact. End note.)

¶19. (SBU) The food stabilization program also has long-term implications for the budget and the economy. The large fuel subsidies that the GOI removed in 2005 mainly affected wealthier car and motorcycle owners. Food subsidies largely help the poor, making their removal politically difficult. Although GOI has limited the soybean stabilization policy to six months, if the global soybean price remains firm beyond the six-month horizon, discarding the subsidy policy will likely entail a political cost.

Longer-term Impact of Policies

¶110. (SBU) Views on the effectiveness of the policy package are mixed. Most analysts applaud the GOI plan to stimulate agriculture production and remove import duties, but believe the retention of export taxes on cooking oil will be ineffective. Observers also note that the longer the food price subsidies are in place, the greater the costs. If global prices continue to rise as expected,

JAKARTA 00000286 003 OF 003

the GOI must increase subsidies to keep pace. The corresponding increase in the budget deficit could prompt a loss of confidence among investors and undermine Indonesia's hard won macroeconomic stability. Food price subsidies can also lead to hoarding; the subsequent shortages can lead to significant unrest, undermining the initial objective of the policy.

¶111. (SBU) Artificially lower food prices also reduce Indonesian farmers' incentive to increase production and lower the quality of food imports. A local representative from Cargill recently observed that price ceilings would force his firm to export markedly lower quality beans to Indonesia. The government has already announced lower standards on wheat imports. The significant cost of the food subsidy program also makes large-scale investment in rural infrastructure much less likely, further clouding growth prospects for the agriculture sector and job growth in rural Indonesia.

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